Financial Markets

Irving Trust

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Economic Research &
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Friday
(Noon)

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This week was marked by a palpable disintegration of the bond markets, with record yields posted almost everywhere. The Treasury's 30-year bond reached its all-time low price on Monday, an AAA-rated Bell System bond reached the market on Tuesday yielding over 17%, and the Bond Buyer index of 20 municipal bonds rose (yet again) to a new record of 13.10%. Contributing to the higher yields were a variety of factors: the Labor Day doldrums (which made markets quite thin), the temporarily higher Federal funds rate, as well as several economic reports which on balance pointed to continuing momentum in the economy.

But the dominating factor was the spreading realization that the Administration's projections for the Treasury deficit were overly rosy. Though that prospect has been in evidence for some time, it seemed as though scarcely a day passed this week without some journalist announcing the "autumn chill" in the Administration. In this setting it is worthwhile considering where the problem really lies. In essence, the markets perceive that fiscal policy is stimulative, while monetary policy is highly restrictive--a combination fraught with potential for continuing high interest rates, in the view of most market participants.

Why the large deficits? Near term, the tax cuts and step-up in military expenditures are only part of the problem--more important are the huge interest costs of the Treasury, together with the sluggish economy's adverse impact on its revenue/expenditure balance. Of course, these problems were not intended to occur: the supply-side vision of a few months back held that the expectations of individuals and firms would be transformed swiftly to spur economic activity, while allowing interest rates to decline. A reduction in the rate of growth of the money stock was part of the background contributing to the revision of expectations, but otherwise did not have a major impact on the projections. Actually, if a wholesale shift in inflationary expectations actually had occurred, many--if not all--of the objectives of the supply-side vision could have been attained. The main problem lies in the process of formation of expectations--the financial markets want to see lower inflation and interest rates endure for a while before placing bets that the shift is permanent. Otherwise expressed: expectations depend on performance. That is especially true in the long-term markets, where investors have repeatedly sustained major portfolio losses over the last several years as yields reached new peaks.

Unfortunately, the Treasury's credibility suffered from this episode. In contrast, that of the Federal Reserve has been buttressed. Though Chairman Volcker would probably be too discreet to tell the Administration "I told you so," in fact the Fed in past months correctly anticipated for the most part the problems likely to arise as a result of the ambitious tax-cut program.

Near term, we expect continued softness of the funds rate to prompt some declines of other short-term rates. However, further rate drops should be gradual.

William C. Melton

Note: The full text of this letter is available to Telerate subscribers on pages 7250-51 on the Monday morning following the Friday date of the letter.

	9/4/81 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	20.50	20.50	11.50%
Effective since	7/8/81		
Discount Rate at Federal Reserve Bank	14.00	14.00	10.00
Federal Funds	16.75	16.25	10.25
Repurchase Agreements	16.75	15.00	9.50
U.S. Treasury Issues			
Bills			
3 months	16.43	16.15	9.68
6 months	17.37	16.94	9.90
1 year	17.22	16.80	9.86
Coupons			
2 years	16.85	16.54	10.78
4 years	16.36	16.10	11.02
7 years	15.63	15.53	11.16
10 years	15.45	15.23	11.17
Long Bond	14.79	14.44	11.00
Negotiable Certificates of Deposit-Secondary Market			
1 month	17.40	17.45	10.30
3 months	17.90	17.70	10.75
6 months	18.05	18.00	11.25
1 year	17.75	17.50	11.50
Banker's Acceptances			
1 month	17.45	17.70	10.20
3 months	17.85	17.75	10.55
6 months	18.10	18.10	10.75
Eurodollar Deposits			
1 month	18.13	18.25	10.75
2 months	18.44	18.50	11.25
3 months	18.69	18.75	11.50
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	16.75	15.00	9.00
1 month	17.13	17.25	9.88
3 months	17.00	17.00	9.88
Bank Holding Companies			
1 month	17.13	17.25	9.63
Dealer Placed:			
3 months	17.00	17.13	10.13
New AA Corporate Utility Bond	17.63	17.30	12.88
Tax Exempt			
6 month Project Notes	9.75	9.00	5.80
1 year AAA Bond	9.50	9.00	5.60
5 year AAA Bond	10.20	9.60	6.00
20 year AAA Bond	13.10	12.10	8.20

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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